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No. 06-1286

IN THE

Supreme Court of the United States

MICHAEL J. KNIGHT, TRUSTEE OF THE WILLIAM L. RUDKIN TESTAMENTARY TRUST,

Petitioner,

v.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

On Petition for Writ of Certiorari to the United States Court of Appeals for the Second Circuit

REPLY BRIEF FOR PETITIONER

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The Solicitor General agrees that there is "a conflict among the circuits concerning the applicability of 26 U.S.C. 67(e)(1) to investment-advice fees paid by a trust," and acknowledges "the importance of the issue to taxpayers and tax administration." Brief for the Respondent in Opposition ("Opp.") 5. He thus does not dispute that the requirements for certiorari are met here. See S. Ct. R. 10(a). The only reason he gives why certiorari should not be granted is that it is possible that the Treasury Department will at some point in the future issue some kind of regulation. The Government's consistent position, including below, has been that § 67(e) is unambiguous, leaving no room for regulatory action interpreting it or for *Chevron* deference. See Br. for Appellee below at 26; *Chevron USA, Inc. v. NRDC*, 467 U.S. 837 (1984). The Solicitor General now argues, though, that a regulation would "likely" resolve the need for review here because under *National Cable & Telecomms. Ass'n v. Brand X Internet Services*, 545 U.S. 967, 982-983 (2005), reasonable regulations due *Chevron* deference can trump prior Court of Appeals constructions of statutory language so long as those courts have not held the statutory language "unambiguous." He candidly acknowledges that there is not even a "final draft" of a regulation and that "staff-level review" is not yet complete. Opp. 6. He does not provide the text even of the nonfinal draft regulation he asserts is under review.

First, because interpretive tax regulations do not receive *Chevron* deference, and because courts on different sides of the Circuit split here have in any event held the statutory language unambiguous, no regulation could resolve under *Brand X* the issue that divides the Circuits in this case. Second, it is not the practice of this Court to deny certiorari based on the mere potential that anticipated action by some other branch will affect the need for review. *See, e.g., Gonzales v. Duenas-Alvarez*, 127 S. Ct. 35 (2006) (granting certiorari in the face of pending legislation that would have resolved the issue presented); *Rush Prudential HMO, Inc. v. Moran*, 533 U.S. 948 (2001) (same); *Thomas v. Outboard*

Marine Corp., 479 U.S. 811 (1986) (same). That is especially true where, as here, the supposedly problem-solving regulation has not even been finally drafted.

I. No Regulation Could Resolve the Need for Review Here

A. The Solicitor General's argument (Opp. 6.) is premised upon an as-yet-unwritten final regulation "interpreting Section 67(e)(1)." But such a regulation would not affect the need for review here. What the Solicitor General posits is an interpretive tax regulation. Such regulations are not given *Chevron* deference by this Court, but are measured under the weaker *National Muffler* standard of deference. *Boeing Co. v. U.S.*, 537 U.S. 437, 448 (2003) (citing *Cottage Sav. Ass'n v. Comm'r*, 499 U.S. 554, 560-561 (1991), in turn citing *National Muffler Dealers Assn.* v. *U.S.*, 440 U.S. 472, 476-477 (1979)); see Salem, *et al.*, *ABA Section of Taxation Report of the Task Force on Judicial Deference*, 57 TAX LAW. 717, 761-763 (2004) (Court adheres to *National Muffler* rather than *Chevron* in cases involving interpretive tax regulations). As *Brand X* makes clear, judicial decisions are unaffected by subsequent "agency interpretations to which *Chevron* is inapplicable." 545 U.S. at 983. Even if Respondent's hypothesized regulation were promulgated, the differing decisions of the Courts of Appeals on the question presented would thus under *Brand X* "remai[n] binding law" in their respective Circuits. *Id.* The Circuit split would be unaffected, s would the need for review.

B. Further, even a regulatory construction of § 67(e) due *Chevron* deference could not resolve *this* Circuit conflict. As the Solicitor General describes (Opp. 7), the conflicting decisions of the Second Circuit below, on the one hand, and the Fourth and Federal Circuits, on the other, all found the language of § 67(e) "unambiguous." *See* Pet. App. 15a; *Scott v. United States*, 328 F.3d 132, 139 (CA4 2003).[1] Under *Brand X*, "A precedent holding a statute to be unambigu-

[1] It is clear, contrary to the Solicitor General's suggestion (Opp. 7), that the Fourth Circuit found no ambiguity in the relevant statutory language, since it refused for that reason to consult its legislative history.

ous forecloses a contrary agency construction." *Brand X*, 545 U.S. at 984. Thus, even if *Chevron* deference were appropriate, no regulation construing § 67(e) could resolve the conflict here. As Respondent essentially concedes (Opp. 7-8), these divided Circuits at least would remain bound to their constructions of the statutory language they found unambiguous.[2]

Respondent argues that the split between the court below and the Fourth and Federal Circuits is of "little or no practical significance." Opp. 8. To the contrary, there is an enormous difference between their two standards; it is dispositive of this appeal and implicates a wide range of trust expenses from investment expenses to accounting and attorney fees. Petitioner argued below that he was entitled to the full deduction for his investment advice expenses even under the Fourth and Federal Circuits' *Scott/Mellon Bank* test because those costs are not of a type "commonly" incurred by individuals. See Pet. 27, 29. The Second Circuit did not reach this issue because it adopted its "more restrictive" reading of the statute to permit full deductibility by trusts only of administrative costs that could not be incurred by an individual. Even if Respondent's hypothetical regulation would be due *Chevron* deference it could not eliminate the issue in this case or affect the need for review.[3]

II. This Court's Practice is Not to Deny Otherwise Appropriate Review Because of the Mere Potential For Resolution of the Need for Review By Another Branch

Of course, more basically, there is no regulation or even a final draft of one here. The words of counsel in a parallel circumstance seeking cert. in *Rush Prudential HMO, Inc. v. Moran*, 536 U.S. 355 (2001), are apt:

[2] And, indeed, there is no indication that the Sixth Circuit found any ambiguity in the statutory language either. See *O'Neill v. Comm'r*, 994 F.2d 302, 304 (CA6 1993).

[3] A regulation "adopting the interpretation of Section 67(e)(1) embraced . . . below" (Opp. 6) would be unreasonable, and thus for a second reason not entitled to *Chevron* deference. Whatever ambiguity § 67 may have, it is clear the word "would" does not mean "could." Pet. 23-24.

> The Solicitor General agrees that there is a stark conflict between the circuits . . . and that th[e] question [presented] "is an important one." . . . Yet the Solicitor General recommends against a grant of certiorari because legislative proposals pending in Congress might—if passed and signed by the President—forestall the need for review here. This Court should not stay its hand in favor of the mere *potential* for legislative resolution of this critical question, over which the circuits are in conflict *now*. . . .
>
> This Court typically turns aside the suggestion that it should not decide an issue of national import in a case that satisfies the stringent requirements for certiorari, *see* S. Ct. Rule 10(a), simply because Congress is concurrently considering the issue. *See* Br. for Respondent in *BMW of North America, Inc. v. Gore*, No. 94-896, at 14-15 (noting that "Congress has considered, as part of the legislative debate, virtually all the proposals that BMW and its amici seek to constitutionalize," and that "[t]o date, the House of Representatives and the Senate have each enacted legislation [imposing federal constraints on punitive damage awards] that is being reconciled in conference"). That is an appropriate response. . . . For this Court generally to refrain from deciding issues that Congress may—but may not—address would impede this Court in its historic task of resolving live circuit conflicts such as the one created by the [Court of Appeals's] decision here.
>
> Legislative proposals, even those being "actively consider[ed]" by Congress, Br. for United States at 9, are still just that: proposals. . . . It is also a particularly cavalier response for the Solicitor General to offer, given the very real practical problems the current conflict poses for [those affected by it.] . . .

Supplemental Brief for Petitioner, *Rush Prudential HMO, Inc. v. Moran*, No. 00-1021, at 1-4 (2001).

This Court granted certiorari in *Moran*, and it should do so here. See also, *e.g.*, *Duenas-Alvarez*, 127 S. Ct. 35 (granting certiorari in parallel circumstance though both Houses of Congress had passed language to resolve issue); *Thomas*, 479 U.S. 811 (1986) (granting cert. in parallel circumstance though Conference Committee had agreed on the relevant language to be included in the final bill). The potential for resolution of the conflict here by another branch is at least as speculative as it was there, lying at best several years (and many billions of tax dollars) in the future. Even if a final regulation could resolve the Circuit conflict, the Solicitor General can offer no assurance–and does not purport to–that such a regulation *will* be adopted that *will* address the issue before the Court, or even that a final draft will be produced.

A. No regulation, or even proposed regulation, has been promulgated and there is no reason to believe any final regulation will address the issue presented here.

There is no regulation, nor even any proposed regulation, that addresses the meaning of § 67(e). The Treasury Department has not promulgated even an interim or temporary regulation. This statute was passed 21 years ago. The first Court of Appeals ruling rejecting the Commissioner's position was handed down 14 years ago. See *O'Neill v. Comm'r*, 994 F.2d 302, 304 (CA6 1993). Yet IRS and Treasury staff have not even agreed upon a draft of any relevant regulation.

The Solicitor General does not even assert that any final regulation will actually address the question upon which the Circuits are divided. He says only that "the process of preparing a proposed rulemaking" is "underway." Opp. 6. He notes that the IRS's 2006 Priority Guidance Plan ("PGP") includes among the 264 projects listed as "priorities" for providing further guidance, the provision of "Guidance under section 67 regarding miscellaneous itemized deductions of a trust or estate." See Office of Tax Policy & IRS, Department of the Treasury, 2006-2007 PGP at 10 (August 15, 2006). The Solicitor General says that a draft of a notice of pro-

posed rulemaking is being examined by staffers "[i]n accordance with" the PGP. Opp. 6.

To begin with, the PGP is itself only a kind of internal "to do" list for the IRS. Its promulgation is not required and completion of the projects on it is not mandated by law or regulations. There are thus items that have remained on that list unaddressed for many, many years. For example "Regulations under section 529 regarding qualified tuition programs," which is on the current PGP has appeared on every annual list since 1999. Compare Updated 2006-2007 PGP at 9, available at http://www.irs.gov/pub/irs-utl/2006-2007pgp.pdf with 1999 PGP at 5, available at http://www.treasury.gov/press/releases/reports/tpplan99.pdf

Second, while the PGP frequently states that what will be provided is "Regulations," with respect to § 67 it states only that "Guidance" will be provided. IRS Guidance can take many forms, including revenue rulings and procedures, notices and technical advice memoranda. The PGP would be satisfied by the issuance of any of these, even if the IRS "presently intends . . . to commit resources" to issuing a regulation. Opp. 5-6. The Solicitor General's argument for denial of course turns upon the hypothetical regulation he posits being entitled to *Chevron* deference. See Opp. 6-7. Even if the regulation he posits would be entitled to that deference, but see *supra*, other forms of IRS guidance are not.

Third, the PGP doesn't say the guidance will address the meaning of § 67(e), nor does the Solicitor General. The PGP says the IRS hopes to issue "Guidance under section 67 regarding miscellaneous itemized deductions of a trust or estate." See Updated 2006-2007 PGP at 15. This is a broad topic including other subsections of § 67. A regulation addressing any one of them would satisfy the PGP.[4]

[4] A "proposed regulation" of which Petitioner is aware would satisfy the PGP even though it would have no impact on this case. That regulation is described in an internal IRS Memorandum dated May 10, 2006, that would deal with whether *under § 67(a)* the two-percent floor applies to deductions on the individual income tax returns of beneficiaries receiving income from trusts, *not* with deductions made by trusts *under §*

Most significantly, the Solicitor General *does not even tell this Court what the "draft of the notice of proposed rulemaking" says*, even though the "staff-level review" is said to be scheduled for completion *three business days* after the filing of the Government's Brief in Opposition. Opp. 6. Indeed, the Solicitor General says only that the regulatory process is "[i]n accordance with the PGP," which means it could relate to anything having to do with "miscellaneous itemized deductions of a trust or estate" under any part of § 67. There is thus no evidence – and the Government does not assert – that a regulation is even anticipated that will "adop[t] the interpretation of Section 67(e)(1) embraced by the court below." Opp. 6 (asserting that review would not be necessary "if" such a regulation were adopted).

B. Any final regulation is likely years away.

Beyond this, there is all that stands between the Solicitor General's unpresented "draft," Opp. 6, and a properly promulgated final regulation that might be entitled to some deference. First, no text has even been finalized. "Staff-level review" – the lowest level – is itself not yet complete. Because of its internal inconsistencies, see Pet. 28, the Commissioner's position presents a difficult, even impossible, interpretive and thus regulatory problem, one that the IRS has refused to address for decades. The steps between a nonfinal draft and a notice of rulemaking at the IRS are complex. Generally drafts are distributed to 16 types of IRS offices. See Internal Revenue Manual 32.1.6.7.2 available at http://www.irs.gov/irm/part32/ch01s07.html. The procedures at the staff-level include review and comment by all

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67(e) on their fiduciary income tax returns. See Reply Brief Appendix 1a (reprinting Memorandum). Respondent does not say this is the proposed regulation to which he refers, but, if adopted, it would be irrelevant to the need for review in this case. Under it the fiduciary tax return filed by a trust itself would be "unchanged," and precisely the same under "current or proposed law." Rep. Br. App. 7a. This case is about how the deduction affects *the Trust's* income (specifically, its capital gains, taxed at the trust level, retained as corpus, and not included in the income distributed to beneficiaries).

affected IRS offices and counsel. *Id.* 32.1.6.7. There are complex disagreement resolution procedures. *Id.* 32.1.6.3. Once a draft is "final," it must be reviewed and approved by a Branch reviewer, an Assistant or Associate Chief Counsel, a Deputy Chief Counsel, the Chief Counsel, the Assistant to the Commissioner, and the Commissioner. *Id.* 32.1.6.8.4. Then it must undergo review anew at Treasury, beginning with an Attorney-Advisor, then the Tax Legislative Counsel, and up through the Assistant Secretary for Tax Policy. *Id.*

More significantly, any proposed regulation would then have to survive notice and comment intact. Notice and comment on tax regulations typically stretches into a several-year process. See, *e.g.*, 26 CFR 1.643(b)-1 (notice of proposed rulemaking issued February 15, 2001, final regulation published January 2, 2004). Sometimes it can take as long as fifteen years. See, *e.g.*, 26 CFR 1.401(a)(9)-1 (notice of proposed rulemaking issued July 27, 1987, final and temporary regulations published April 17, 2002). Adoption of any regulation like the hypothetical one the Solicitor General says would cut against certiorari review here would face enormous opposition from the most important relevant elements of the bar and the financial services industry. The American Bar Association Section on Real Property, Probate and Trust Law on April 28, 2007, adopted a recommendation asking the ABA Board of Governors to pass a resolution urging "that Section 67(e) . . . be interpreted to allow a trust or estate a full deduction from gross income for investment management and advisory fees." Reply Br. App. 10a; see also Brief *amicus curiae* of American Bankers Association, *et al.* 7-13. There is no reason to think (and Respondent does not say) there is a quick regulatory fix here.

C. There is no adequate basis for denial here.

As this Court and the Solicitor General have recognized, the likelihood and timing of action by another branch that may affect a case pending before this Court are the significant factors in this Court's determination how to proceed. See, *e.g.*, Petition for Certiorari, *Gonzalez v. Duenas-*

Alvarez, 05-1629, at 22 (2006) (successful certiorari petition of Solicitor General arguing that while both Houses of Congress had passed legislation that would have resolved Circuit split and need for review, bill's final passage was "[a]t this point . . . uncertain"); Petition for Certiorari, *Thomas v. Outboard Marine Corp.*, No. 85-1735, at 17 (1996) (same, arguing that although congressional conferees had agreed upon provision that would have resolved the need for review, "prospects for and timing of final passage. . . are . . . uncertain"). The likelihood of a timely or relevant final regulation affecting the split in authority here (even if one could) is even less than the likelihood of timely resolution in cases like *Duenas-Alvarez*, *Moran* or *Thomas*. There, statutory text that would have altered the legal landscape was at least pending before Congress, and would have had immediate effect if enacted into law. This is far more speculative.

The Solicitor General ultimately concedes that his regulation will be issued only "barring substantive or policy-level objections" at the IRS or Treasury Department. Opp. 6. He thus asserts essentially that the IRS and Treasury will issue a regulation if they decide to. And he merely claims that what comes out of the regulatory process will "likely" resolve the issue in this case. Opp. 5. The same could be said in almost any case presenting a split in authority about a statute that is administered by a federal agency.

The Solicitor General knows and has long known what has to be done if the Government is to attempt to employ its regulatory authority to prevent this Court's review of an otherwise certworthy issue. See, *e.g.*, Brief for Respondent, *Mouelle v. Gonzales*, No. 05-1092, at 4 (2006) (Solicitor General Clement) ("DHS and DOJ have . . . 'undertaken to resolve the [circuit] conflict by issuing interim rules, effective [prior to the date of the Brief in Opposition] that repeal [regulations about the validity of which the Circuits are divided]."); Brief for the United States in Opposition, *San Pedro v. United States*, No. 96-40, at 10 (1996) (Acting Solicitor General Dellinger) ("[T]o resolve the uncertainty" cre-

ated by a split among the Circuits concerning the power of a United States Attorney to bind the INS, "the Attorney General . . . issued new regulations" prior to submission of the Brief in Opposition and effective within days thereafter codifying the scope of that power.). Here there is not even a temporary regulation. Even under the pressure of the Solicitor General hoping to avoid review by this Court, the Government has failed to make a credible start. And in failing to provide this Court with the text of any proposed regulation, Respondent deprives it, and Petitioner, of the necessary and appropriate opportunity to evaluate whether and how that regulation would actually affect the issue before the Court.[5]

Finally, it would be particularly inappropriate to deny review on this speculative basis in a case like this. The issue in this case involves billions of dollars annually and recurs constantly. Yet if the Court denies review here, it is not likely to see another case presenting this issue for many, many years. This case presents a classic free rider problem. While the total amount of tax liability is enormous, each taxpayer's is not. Here, for example, $4,448.00 is at issue. The cost of litigation thus far exceeds the economic benefit any individual taxpayer stands to gain. Nonetheless, taxpayers should in coming years be able to deduct the expenses at issue, if that is what is permitted by law. At the same time, the Commissioner deserves a clear ruling if his position is right.[6]

CONCLUSION

The Petition for Writ of Certiorari should be granted.

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[5] Even if it were possible that a regulation could resolve the division in authority here, which it is not, such a regulation would not eliminate all the reasons review is appropriate. It would not affect Petitioner's case, nor the tax liability of the myriad other taxpayers filing affected returns prior to its effective date. Significantly, Respondent does not claim this is an insignificant category. With expenses each year for investment advice estimated in the billions of dollars, the effect of the decision below on this class alone is enormous.

[6] Respondent does not actually defend the decision below (which rejected his position), arguing only that it is "reasonable." Opp. 8. His merits arguments (Opp. 8-13) are adequately addressed in the Petition.

Respectfully submitted,

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JUNE 4, 2007

APPENDIX

APPENDIX A

DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
Washington, D.C. 20224

SMALL BUSINESS/SELF-EMPLOYED DIVISION

May 10, 2006

MEMORANDUM FOR CHIEF COUNSEL

FROM: K. Steven Burgess */s/ Monica L Baker*
Director, Examination

Bill Conlon
Director, Specialty Programs

SUBJECT: Proposal to Issue Regulations under Internal Revenue Code Section 67 for the 2 Percent Floor on Miscellaneous Itemized Deductions

Introduction

The purpose of this memo is to request that regulations be issued under Temporary Treasury Regulation §1.67-4T, entitled "Allocation of expenses by non-grantor trusts and estates (temporary)" which is currently "reserved." This regulation is needed to close a loophole that allows certain individual taxpayers (generally high income) to indirectly claim tax benefits that they cannot directly claim. This loophole not only perpetuates unfairness but also contravenes

Congressional intent and, based on preliminary data, results in sizeable annual losses of tax revenue.

Because the Internal Revenue Service (Service) previously was unable to systemically identify those individuals using the loophole, it had not requested regulations to correct the problem (which has existed since Section 67 was added to the Internal Revenue Code (IRC) in 1986). Now, however, the Service has the capability, through its Schedule K-1 matching program, to systemically identify individuals using this loophole, and the proposed regulations could be enforced.

Background

Internal Revenue Code Section 67 limits otherwise allowable miscellaneous itemized deductions for individuals and certain entities to the amount that exceeds 2 percent of adjusted gross income. In applying the 2 percent floor to trusts and estates, adjusted gross income (AGI) is computed in the same manner as in the case of an individual, except that certain deductions are allowed in full. Among these deductions is an "income distribution deduction" (IRC Section 67(e)(3)) that is equal to the amount of income distributed or required to be distributed annually. For a trust that distributes (or is required to distribute) all of its income annually, IRC Section 67(e)(3) operates to significantly reduce or eliminate the trust's AGI, and thereby significantly reduce or eliminate the impact of IRC Section 67(a).

The following example compares the impact of Section 67 on a trust beneficiary with the impact of that section on an individual who holds income-generating assets directly. This example assumes that the trust beneficiary or individual has no other income or deductions.

Trust Beneficiary	
Trust income:	1,000,000
Administrative expenses:	120,000
Individual distribution deduction:	880,000
Exemption:	300
Trust taxable income:	(300)
Investment advisory fees (subject to the 2 percent limitation):	200,000
Amount of reduction of deduction (i.e., 2 percent of trust taxable income):	0
Deductible investment advisory fees:	200,000

Individual Holding Assets Directly	
Income:	880,000
Investment advisory fees:	200,000
Amount of reduction of deduction (i.e., 2 percent of gross income):	17,600
Deductible investment advisory fees:	182,400

Because of the $880,000 distribution deduction and the $300 exemption, the trust's AGI is $(300). As set forth above, applying the 2 percent limitation on this negative AGI produces no limitation on the miscellaneous deduction. The entire $200,000 is deducted at the trust level and the beneficiary receives and reports income from the trust in the net amount of $680,000. Thus, the trust (and indirectly the beneficiary) is able to claim the entire $200,000 in investment advisory fees as a miscellaneous itemized deduction—even though the fees are theoretically subject to the 2 percent limitation of IRC Section 67. In contrast, the individual holding the assets directly must report $880,000 income and can claim only a miscellaneous itemized deduction of $182,400. As a result, the trust beneficiary can indirectly deduct an additional $17,600 that he would not be

able to deduct if paid directly by him as an individual.[1] Because the limitation of IRC Section 67 is circumvented as a result of the application of distribution deduction, that limitation is also circumvented in complex trusts and estates to the extent that those entities claim distribution deductions.

Internal Revenue Code Section 67(c)(1) provides that "[t]he Secretary shall prescribe regulations which prohibit the indirect deduction through pass-thru entities of amounts which are not allowable as a deduction if paid or incurred directly by an individual." Internal Revenue Code Section 67(c)(3)(B) states, however, that the prohibition of indirect deductions shall not apply to estates and trusts "except as provided in regulations." In 1988, the Service issued Temp. Treas. Reg. §1.67-2T, which applies to grantor trusts and a variety of other pass-through entities but does not apply to non-grantor trusts and estates. That regulation permits the specified entities to pass through without reducing the total amount of deduction that would otherwise be subject to the 2

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[1] In addition to §67, §68 reduces the amount of the itemized deductions otherwise allowable for the taxable year for high income taxpayers, while trusts are not subject to §68. Section 68 states that "the amount of the itemized deductions otherwise allowable for the taxable year shall be reduced by the lesser of: 3 percent of the excess of adjusted gross income over the applicable amount, or 80 percent of the amount of the itemized deductions otherwise allowable for such taxable year." Beginning in 2005, the "applicable amount" of adjusted gross income, above which the amount of otherwise allowable itemized deductions reduced is $145,950 (or $72,975 for a separate return filed by a married individual). *See* § 3.11 of Rev. Proc. 2004-71. Thus, the disparity between the deduction available to an individual without a trust and an individual who is the beneficiary of a trust is further increased.

percent floor but requires the beneficiary, partner, S-shareholder or other individual to whom amounts are distributed to apply the 2 percent floor based on his or her own individual adjusted gross income. The regulation designed to address non-grantor trusts and estates, Temp. Treas. Reg. §1.67-4T, entitled "Allocation of expenses by non-grantor trusts and estates (temporary)," is "reserved," but no language has ever been issued. *See* INCOME TAXATION OF FIDUCIARIES AND BENEFICIARIES, Byrle M. Abbin (2001 Ed.) section 310 stating "Generally, the 2 percent floor on miscellaneous itemized deductions is to be applied at the fiduciary level. However, IRC Section §67(c) authorizes the Treasury to issue regulations that would apply the 2 percent at the beneficiary level in the case of a simple trust. To date, the Treasury has not exercised its regulatory authority on this matter."

Discussion

Internal Revenue Code Section 67(c)(3) expressly states that the prohibition against indirect deductions shall not apply to estates and trusts "except as provided in regulations." Absent language under Temp. Treas. Reg. §1.67-4T, an individual who is a beneficiary of a trust can claim certain deductions in excess of the 2 percent limitation intended by Congress, while a similarly situated individual who holds those same assets directly would be limited by IRC Section 67(c)(1), as well as IRC Section 68.

Internal Revenue Code Section 67 was added to the IRC as part of the Tax Reform Act of 1986. Congress sought to address its concern that "under present law, some taxpayers can exclude or deduct from income certain items that differ little from items that are . . . nondeductible expenditures for other taxpayers." H. Rep. No. 99-426, at 57 (1986). *See Mellon Bank, N.A., Trustee v. United States*, 265 F.3d 1275, 1281 (2001) (addressing the application of the 2 percent floor

to a trust—not its beneficiaries—and observing that the legislative intent of TRA 1986 is to . . . "limit the ability of sophisticated individuals to use trusts or other complex arrangements to lower their tax burden compared to similarly situated individuals.") Moreover, in the House Report to the subsequent Technical Correction Act of 1988 (P.L. 100-647), Congress expressed its expectation that the Service would apply the 2 percent limitation to trust beneficiaries, stating that the bill modifies IRC Sections 67(c) and 67(e) to make clear that "the Treasury has regulatory authority to apply the two-percent floor at the beneficiary level, rather than at the entity level, with respect to trusts required to distribute income currently." S. Rep. No. 100-445, at 12 (1988).

Research information indicates that claiming unlimited miscellaneous deductions may be widespread and involves sizeable amounts. For Tax Year 2002, 983 simple trusts with income greater than $25,000 claimed distribution deductions and miscellaneous itemized deductions and the total amount of miscellaneous itemized deductions claimed by all simple trusts (including those with income less than $25,000) was $275 million. Similarly, for TY 2003, 1,197 simple trusts with income greater than $25,000 claimed distribution deductions and miscellaneous itemized deductions and the total amount of miscellaneous itemized deductions claimed by all simple trusts (including those with income less than $25,000) was $311 million. We do not currently have information to allow us to estimate the amount of the miscellaneous itemized deductions that would be eliminated through promulgation of the proposed regulation. A recently completed Compliance Initiative Project (CIP) reviewed 137 simple trust TY 2003 returns with the highest incomes that claimed both miscellaneous itemized deductions and distribution deductions. These trusts claimed a total of $245 million in distribution deductions and $49 million in miscellaneous itemized deductions. All of the beneficiaries

associated with analyzed returns failed to report any portion of the miscellaneous itemized deduction and, instead, reported only the net income that they received from the trust. Virtually all of the beneficiaries were high-income taxpayers and the amounts they claimed for other (non-trust) miscellaneous itemized expenses were significantly reduced by the 2 percent limitation of IRC Sections 67 and by §68.

The following example is based on the income and miscellaneous itemized deductions from an actual CIP case. (For simplicity, it does not include other attributes from the tax returns, such as Schedule D, Capital Gains and Losses, information.) It compares the treatment of a trust beneficiary under current law and under the proposed regulations.

Trust Return (unchanged under current or proposed law; impact on beneficiary will change as shown below)

- Trust income: 3,159,746
- Misc. expenses: 1,327,990
- Individual distribution deduction: 1,831,756
- Exemption: 300
- Trust taxable income: (300)
- Amount of reduction of misc. itemized deduction (i.e., 2 percent of trust taxable income): 0
- Misc. itemized deduction: 1,327,990

Individual Return—under current law

- Taxpayer reports total adj. gross income: 3,243,741
  - 1,831,756 of income from trust
  - 1,411,985 of other income
- Taxpayer misc. expenses 323,269
  (no share of trust misc. expenses)
  (subject to 2 percent limitation)
- Taxpayer's misc. itemized deduction is reduced by (AGI multiplied by 2 percent) 64,875

- Taxpayer reports misc. itemized deduction: 258,394
  (No share of trust misc. deduction)

Individual Return—under proposed regulation

- Taxpayer reports total adj. gross income: 4,571,731
  - 3,159,746 of income from trust
  - 1,411,985 of other income
- Taxpayer misc. expenses
  (subj. to 2 percent limit) 1,651,259
  - Trust 1,327,990
  - Non-trust 323,269
- Taxpayer's misc. itemized deduction is
  reduced by (AGI multiplied by 2 percent) 91,435
- Taxpayer reports misc. itemized deduction: 1,559,824
  (No share of trust misc. deduction)

Under the current law, the beneficiary claims directly or indirectly miscellaneous itemized deductions totaling $1,686,385 (i.e., the trust return deduction of $1,327,990 and individual return deduction of $258,394). In contrast, under the proposed regulation, the beneficiary directly claims miscellaneous itemized deductions of $1,559,824—placing him in the same position as a taxpayer who incurs those expenses outside of a trust. (Applying IRC Section 68 would further reduce the allowable itemized deduction.)

The importance of the proper application of IRC Section 67 will likely increase. The courts have begun to clarify that certain types of trust expenses previously not consistently held to be subject to IRC Section 67 are, in fact, subject to that provision. In this regard, one court of appeals had held that investment advisory fees incurred by a trust were not subject to IRC Section 67—even though they would be limited by IRC Section 67 if incurred by an individual. *O'Neill v. Commissioner*, 994 F.2d 302 (6th Cir. 1993). More recently, however, two other courts of appeals have

held that such trust expenses are properly subject to IRC Section 67. *Scott v. United States*, 328 F.3d 132 (4th Cir. 2003); *Mellon Bank, N.A. v. United States*, 265 F.3d 1275 (Fed. Cir. 2001). *See also William R. Rudkin Testamentary Trust v. Commissioner*, 124 T.C. 19 (2005) (following the holding of the *Scott* and *Mellon* cases).

Conclusion

The IRS is unable to close this loophole without regulations. Closing this loophole would promote tax equity, and advance Congressional intent, as well as advance the first objective listed in the IRS Strategic Plan 2005-2009. That objective is to "Discourage and Deter Non-Compliance with Emphasis on Corrosive Activity by . . . High-Income Taxpayers and Other Contributors to the Tax Gap." (Strategic Plan p. 18-20.) Specifically, it would address two specific priority areas of the objective, i.e., the "underreporting of income by higher income individuals" and "flow-through income." (Id.)

If you have any questions about the issue, please contact Jan Geier, SB/SE Division, Special Counsel, at (202) 283-7661 or Scott Emerson, SB/SE Trust Technical Advisor, at (202) 320-2803.

APPENDIX B

AMERICAN BAR ASSOCIATION
SECTION OF REAL PROPERTY, PROBATE, AND TRUST LAW

REPORT TO THE HOUSE OF DELEGATES

RECOMMENDATION

RESOLVED, That the American Bar Association recommends that Section 67(e) of the Internal Revenue Code be interpreted to allow a trust or estate a full deduction from gross income for investment management and advisory fees in arriving at its adjusted gross income, and that these expenses not be subject to the general rule of Section 67(a), which allows miscellaneous itemized deductions only to the extent that the aggregate of those deductions exceeds two percent of adjusted gross income.